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The Lion Dancer

"O.K., everyone … line up again. This will be our last rehearsal before the event tomorrow morning."

"*Remember, the first movements are lunge right … then lunge left … then dip. If we can begin in perfect unison, we'll make a great first impression and it will be 'smooth sailing' from thereon!*"

"*Excuse me,*" said one of the Lion Dancers, still in her costume. "*Some of us have exams tomorrow and it would be helpful to have a couple of hours to study tonight. When may we expect to be finished?*"

"*Well,*" said the leader, "*as college students you may, of course, leave at any time. But perfection requires practice. You do want to dance to impress, don't you?*" The leader smiled as he saw a line of lions' heads nodding up and down. So the Lion Dancer shrugged off studies for another practice of the Lion Dance. Unfortunately for her grades, she actually preferred it that way.

As depicted in the picture here, a Lion Dancer is one of two people who, combined with a costume, form a colorful and exaggerated "lion." A "Lion Dance" (Chinese: 舞獅) is a form of traditional dance in Chinese and other Asian cultures in which Lion Dancers mimic a lion's movements in their costume. Differing from a "Dragon Dance" whereby the "performers" hold one long dragon costume overhead, the Lion Dance is usually performed during the Chinese New Year and other Asian cultural and religious festivals. It may also be performed at important occasions, such as business opening events, special celebrations or wedding ceremonies, or it may be used to honor special guests. During Chinese New Year, the "lions" eat lettuce and dance so as to give luck to businesses. [The Chinese word for "lettuce" sounds almost identical to the construction "to get rich," with the exception of a tone change on one of the characters.]

The Lion Dancer loved participating in lion dance festivals, finding it excellent exercise as its fundamental movements can be found in most Chinese martial arts. She also developed a camaraderie with her fellow performers. It was a great social pastime for her throughout her college years. But this great social event had a "cost" to the Lion Dancer, one that would not be evident for some years.

In this issue …

Aristotle Capital Management

The Lion Dancer graduated from the university with respectable, though not the highest, grades. As she was not preparing to continue with her studies past a bachelor's degree, the tradeoff between grades and lion dancing seemed worthwhile. Instead, after graduation, to immerse herself even further in Asian culture, the Lion Dancer went to China and taught auxiliary high school classes to students preparing for overseas study. To better communicate with her students, she became fluent in Mandarin. She also volunteered at local hospitals serving the underprivileged. In short, she flourished. In time, she also matured.

Several years later the Lion Dancer decided it was time to resume her studies and returned home to the United States. "*Medical school is what I want,*" she announced to her family. Her father immediately reached to hide his wallet. Her mother jumped for joy, while her sister and uncles nodded approvingly. So back to school she went, at first to a one-year post-baccalaureate program geared for the college graduate who wants to apply to medical/dental/vet schools. No Lion Dancing this time and she excelled. She received straight A grades and a Medical College Admission Test (**MCAT**®) score placing her in the top one-percent of her peers.

"*Great,*" she boasted. "*Now I can go to any medical school I choose!*"

But, alas, it did not turn out that way. Medical schools are very competitive, with some admitting fewer than ***three percent*** of those who apply. How do they winnow the candidate field? Many employ quantitative screening tools, insisting on minimum grades for each level of education. Her most recent results and life experiences would lead most to conclude she had a unique background, well suited to becoming an outstanding physician. But this was not enough, as the Lion Dancer was "screened out."

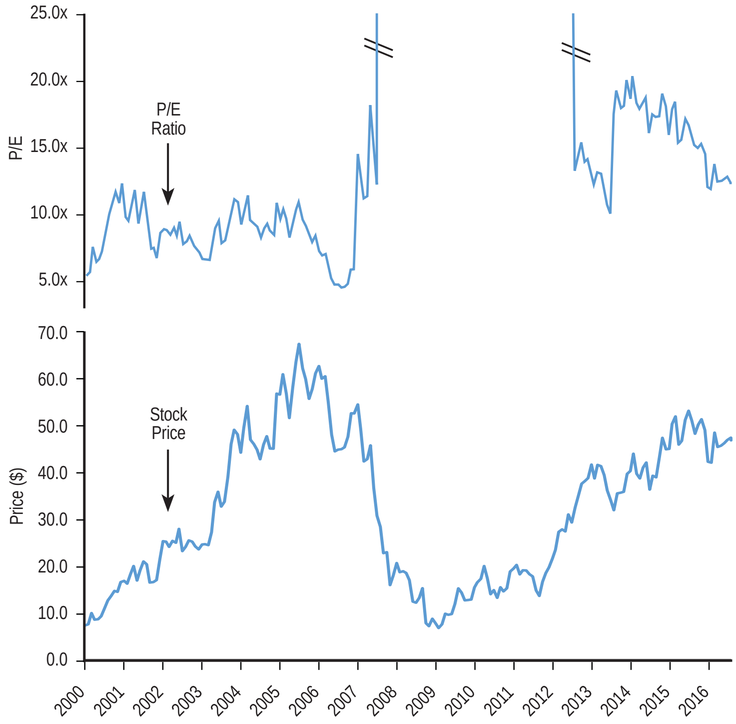
Screens

The story of the Lion Dancer is, we believe, a good analogy as to why we, at Aristotle Capital, typically do not employ a screening process.

It is always easier to explain by example. The following two companies were chosen for illustrative purposes only, not necessarily as "recommendations." As of the time of this writing, the first is a company that has been owned in Aristotle Capital portfolios, while the second has not. First, consider homebuilder **Lennar**.

The top graph above shows the price-to-earnings (P/E) ratio of the company's stock from January 2000 to the present. Note that during the U.S. housing boom of the mid-2000s,

Lennar



Sources: FactSet; Bloomberg; Aristotle internal research

Lennar's P/E ratio declined to nearly 5x. The bottom graph above shows Lennar's absolute stock price. Note that in early 2007, the company's low P/E ratio was **not** due to a low stock price. In fact, it was the opposite, as the stock was near its all-time high at over $60 per share back then. The low valuation was relative to extraordinarily high profitability when U.S. housing starts exceeded two million annually.

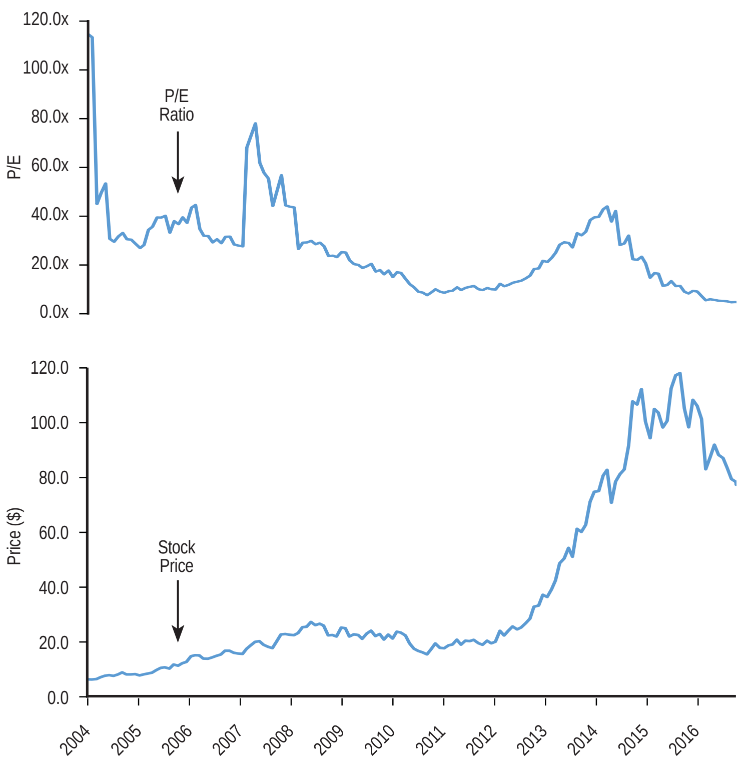
Many value-oriented managers employ screens looking for just this type of anomaly, whereby earnings are high while stock prices have not kept up. But the Aristotle Capital investment philosophy would not have resulted in purchasing Lennar at that time. The company was deemed to be **over** earning due to an unsustainable industry environment. No, the philosophy also would not necessarily have predicted the precipitous decline that followed.

A non-screening process could have, however, resulted in an investment in Lennar in early 2011. The company had built a unique low-cost land position, maintained a sustainable balance sheet and was one of the few homebuilders (of any size) still viable. But note, from the graph above, that the company's P/E was not meaningful at that time as earnings were negligible during the depths of the housing downturn. For opposite reasons as in 2007, the same P/E screen may not have resulted in Lennar's identification as a potential investment. An extraordinary opportunity to purchase (at a very low price) what many believe to be the best homebuilder in America would have been foregone due to a meaningless

P/E screen. Only a fundamental understanding of the company's businesses could have yielded a positive viewpoint.

A second example is biopharmaceutical company **Gilead Sciences**. The stock has been "screening" well of late as the approval and marketing of its Hepatitis-C medications have caused earnings to spike (and thereby its P/E ratio to drop). But how sustainable are those results?

Gilead Sciences



Sources: FactSet; Bloomberg; Aristotle internal research

We have long followed Gilead, as its HIV medications have proven to be a stable and durable franchise. From the above graph, one can see that the company's fundamental strengths were well reflected in its valuation with P/E ratios exceeding 40x. The recent dip in the company's valuation to less than *ten* times earnings could be, to some, a unique opportunity to own such a promising business. Most screens, we argue, would suggest so. But we believe that just as Lennar, at *five* times earnings, preceded a significant stock price drop, the current seemingly low valuation for Gilead could be misleading. Hepatitis-C drug sales are, in our view, far higher than *normal*. The advent of new competition plus fewer available patients (particularly in the U.S., where drug prices are highest), could result in lower earnings for this treatment. Also, while the HIV franchise is still valuable, new treatments from competitor ViiV Healthcare and others, as well as inevitable generic challengers, could prove more formidable than others may be considering. Screening, no matter how thoughtful, would be hard pressed to identify these challenges. Only long-term fundamental analysis could so uncover a future that may be quite different from Gilead's past.

There are nearly as many investment methodologies as there are investment firms. Many rely upon various quantitative methods, including "screening." We do not wish to imply that such methods are without any merit. However, we point out this quarter the potential downfall of relying ***only*** upon screens, particularly as a way to identify investment candidates – or medical school students!

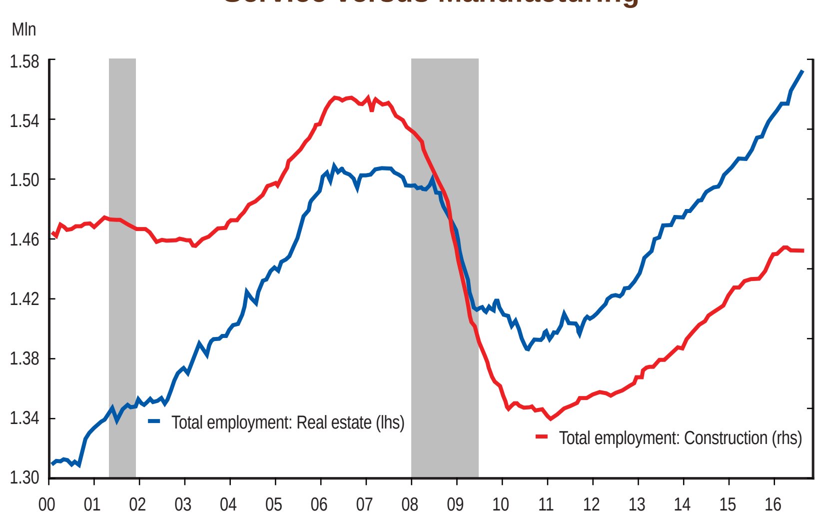
EQUITIES STRATEGY

One of the reasons we typically shun the use of "screens" is that they are inherently **backward** looking. Medical schools, in attempting to identify optimal students, look at their past work. This is good and, of course, we consider the past when learning about businesses. But the Lion Dancer was passed over – more often than she would have preferred – as the schools failed to consider that her undergraduate grades were not necessarily indicative of the performance she would generate as a med school student. Indeed, the times (and study habits) for her had changed.

The following graph is one that we believe illustrates changing times in the U.S. (and global) labor force.

The red line – right-hand scale – depicts employment in the U.S. construction industry. This would include those who

Service versus Manufacturing



Sources: BLS; DB Global Markets Research build structures, including homes, apartment buildings, office buildings, hotels, shopping centers, warehouses, etc. The blue line – left-hand scale – represents employment in real estate. This would include real estate sales, appraisers, rental agents, maintenance, financing, investment, management, etc. In the year 2000 there were a total of 8.1 million persons employed in a combination of both construction and other real estate activities in the U.S. Today, there are nearly the same. But over the past 16 years, including through the Great Recession, construction employment is down somewhat while overall real estate employment has increased. To us, this is a microcosm of an overall shift in all of employment from "goods producing" to "service providing."

We find that such a shift is ongoing in a global sense. As we have pointed out in prior editions of *The Essence* and predecessor publications, commonly used statistics may not fully capture this societal shift. Certainly, in our view, screens would have missed it altogether. These are important issues worthy of further consideration over time.

INVESTMENT ACTIVITY

So, if we do not employ screens, how do we identify investment opportunities? As we have long highlighted, the primary (and secondary and tertiary) task of Aristotle Capital investment professionals is to continually learn about what we believe are the world's best companies. We do not look for "ideas." On occasion, however, some of the companies we analyze will be added to our investment portfolios. On occasion, existing investments could also lead to work that ultimately uncovers companies that, perhaps, are in the process of the types of change that justify additional investment due diligence. We would now like to highlight recent examples of this:

PPG and **Axalta**, (both chemical-based coatings companies), were recently added to select Aristotle Capital portfolios. The work originated from an investment in **BASF**, currently owned in our International portfolios. Recently, on an investment tour to BASF's head office in Ludwigshafen (on the Rhine) in southwestern Germany, the company highlighted its coatings division as one holding great long-term promise. Coatings may be for either architectural applications (in common parlance, "paints," including those used for homes and other structures) or for industrial applications (including autos, typically for protective purposes). Architectural coatings are mostly sold to consumers, (perhaps by way of retail stores such as **Home Depot**), while industrial applications are most always consumed by businesses.

Coincident to this tour, two other participants in the coatings industry announced a merger – Sherwin-Williams and Valspar. Analysis revealed that, while seemingly economically cyclical, the coatings industry was rapidly consolidating. This has led to, and may continue to lead to, "gentler" and elongated cycles, greater predictability and higher returns on invested capital. In particular, we believe that two firms, PPG and Axalta, may be optimal investments for select Aristotle Capital strategies. **PPG** has shed most of its non-coatings businesses and is now more focused and predictable. **Axalta** is now an independent company, having been owned by DuPont previously. We believe both are being viewed in the "rear view mirror" by others, not reflecting the enhanced business environment due to both industry and individual company factors.

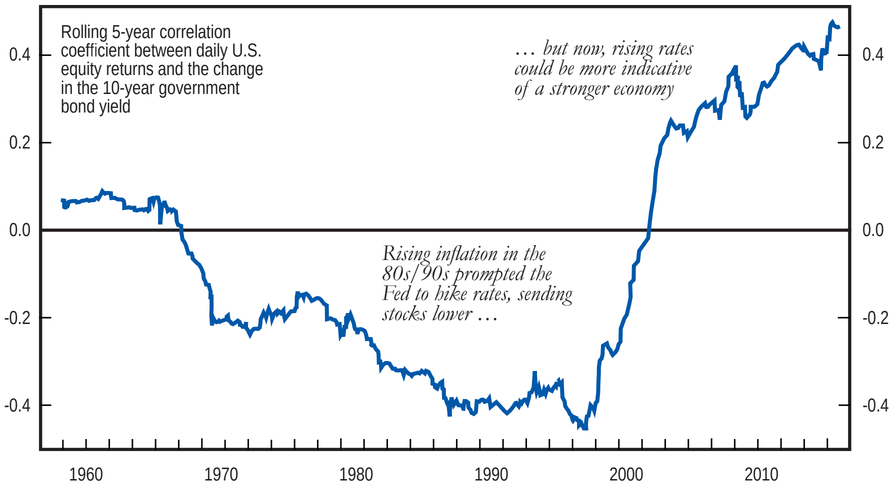
Next, we initially identified **Ameriprise** (AMP) by "screening **IN**," attempting to identify peers of (***Charles***) **Schwab**, a company we had long followed and owned. While we believe that performing exclusionary screens, by itself, may not yield favorable investment results, using screens to find competitors could be a useful tool. We noted that while Schwab was a consistent market share gainer, AMP, too, had been accumulating client assets since it was spun off from American Express a decade ago. The business is significantly different than it was back then, and we believe that may not be fully appreciated by others. AMP's wealth and asset management businesses are benefitting from recent Labor Department rules as smaller players find the regulations difficult to manage. AMP used to be primarily an insurance company (mostly selling annuities), with smaller asset and wealth management units. Today, it's the opposite. Thus, we view its valuation at ten times earnings as, perhaps, average for its ***prior*** insurance peers, but far lower than its current competitive set of asset and wealth managers. Finally, the stock's 3% dividend yield provides stability as the company's transition is, we expect, eventually recognized by others.

FIXED INCOME STRATEGY

The bond market used to be a relatively good predictor of the stock market. Have its predictive powers reversed course? The graph on the following page depicts the relationship between the U.S. stock and bond markets from the 1960s through today.

This graph depicts the correlation between U.S. equity returns and long-term (ten-year) bond yields. A ***negative*** value (as occurred for most of the 1970s, 80s and 90s) means that when interest rates rise, stock prices coincidentally decline. Today, with correlation having a ***positive*** value, this effect is reversed as increases in interest rates are now typically met by ***increasing*** stock prices. This relationship never holds perfectly, as a value of 0.4 means that only about 40% of the change in one is "explained" by the other.

Bond Yields and Equity Returns



Source: The Bank Credit Analyst

While correlations are not necessarily "causal" (meaning there are many other factors involved), in this case there are reasons to believe that, in the near- to intermediate-term, at least, bonds may "predict" stocks. Throughout the world, a major impediment to growth has been stubbornly low growth and low inflation. Policymakers have yet to determine how best to nudge either higher. Originally highlighted by former Federal Reserve Chairman Ben S. Bernanke, global reserve banks have warned of the danger of allowing **de**flation to take hold. It could, they worry, lead to a spiral of low confidence, muted spending, low inflation, minimal income growth and low or no economic growth.

Higher inflation, it is thought, will allow for rising interest rates and break the downward spiral. This could be why higher rates appear to be positively correlated with higher equity prices. As always, we will monitor such global macro trends, but continue to devote the vast majority of our resources to understanding individual businesses.

CONCLUSION

While the Lion Dancer was not considered for admission to her top choices for medical school, she was accepted into some excellent programs. Her family is quite proud of her accomplishments to date as she officially began her journey to an M.D. on September 6 of this year. She truly is a changed person from when lion dancing was her passion. While still a hobby, it now takes its place **behind** other pursuits, including her studies.

A change from one era to another is not easily captured by "screens." Some medical schools missed this change in the Lion Dancer even though there were many clues found in her curriculum vitae. We used the example of the (now) medical school student this quarter as illustrative of how screens may (in the case of screening **in**) and typically do not (as in the case of screening **out**) result in companies of interest.

The economy and financial market indicators, too, can change. We gave examples of construction versus real estate employment as well as stock and bond market correlations. Both have evolved over the past 15 years and both must be looked at differently today than historically. We, at Aristotle Capital, will continue to investigate issues with open eyes, learning from our past, yet knowing that not always will history repeat.

We'd like to close this quarter by paying homage to someone we believe to be one of entertainment's true legends. In his own tribute upon hearing of the person's recent death, actor/director/producer Mel Brooks said:

In another era, his Harpo Marx-like mop of golden hair, his slight physique and his soft, almost lisping voice might have hindered a career as a leading man. But I found him "a natural … an Everyman with all the vulnerability showing." He continued by saying, "One day G-d said, 'Let there be prey,' and HE created pigeons, rabbits, lambs and … Gene Wilder."

In our estimation, heaven is now a bit more complete with Gene Wilder and his former wife, Gilda Radner, together again.

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